SUPREME COURT, U.S.

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NO. 1047

IN THE

Supreme Court of the United States

October Term, 1965

HOMER L. BRUCE, *Petitioner*,

v.

UNITED STATES OF AMERICA, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Homer L. Bruce

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Petitioner, Homer L. Bruce, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above entitled and numbered case (No. 23,642 below) affirming the judgment of the District Court of the United States for the Southern District of Texas, Houston Division, adverse to petitioner.

CITATION TO OPINIONS BELOW

The opinion of the District Court (R. 103-113, Appendix A, hereto, p. 23) is reported in 254 F. Supp. 816. The Court of Appeals simply affirmed the judgment of the District Court in a per curiam opinion reading as follows (R. 117):

"PER CURIAM: We have carefully read the opinion and judgment of the trial court in this case, entered February 10, 1966, 254 F. Supp. 816. We find that it correctly states the legal principles controlling this suit for refund of taxes by appellant. We, therefore, AFFIRM the judgment of the trial court on the opinion of that court."

JURISDICTION

The judgment of the Court of Appeals, affirming the judgment of the District Court, was entered on January 10, 1967 (R. 119, Appendix B, hereto, p. 34). Jurisdiction of this Court is invoked under 28 U.S.C., section 1254(1).

STATEMENT CONCERNING THE RECORD

The record as certified by the clerk of the Court of Appeals and all original exhibits and nine copies of the printed record below are filed herewith. In addition, nine copies of Plaintiff's (petitioner's) Exhibits 1, 2 and 4 are filed herewith. Plaintiff's (petitioner's) Exhibit No. 3 is a unitization agreement of the West Bay Field in Plaquemines Parish, Louisiana, consisting of a 17 page contract, 16 pages of maps and 82 pages of statistics on 16 sands and 329 tracts and because of its length nine copies are not filed herewith.

QUESTIONS PRESENTED

A trust, Trinity Petroleum Trust, owns oil and gas royalties in 36 fields in 6 states. It owns the stock of a small company, Trinity Petroleum, Inc., which owns similar royalties in Louisiana. Both the Trust and Trinity Petroleum, Inc., are prohibited from acquiring any properties other than those acquired at their creation on October 1, 1951. Petitioner and his wife owned as community property

6,152 shares out of the 192,500 shares in the Trust. Petitioner's wife died in 1959 and left her shares to petitioner. The shares were valued at $37 per share for Federal estate tax purposes in her estate and under section 1014 of the Internal Revenue Code petitioner's basis for his shares is that $37 per share. For 1960, 1961 and 1962, the years involved in this case, the Government taxed petitioner on his part of the Trust's net royalty income less 27-1/2% depletion thereof and his portion of the Trust's income by dividends from Trinity Petroleum, Inc., with no allowance to petitioner of any deduction thereon under either section 167 or 611 of the Internal Revenue Code. The record is uncontradicted (1) that on those allowances by the Government petitioner will not recover his basis of $37 per share free of income tax, and (2) it is impossible for petitioner to determine what his allowances under sections 167 and 611 should be on a cost basis.

The questions presented are:

1. Were the courts below correct in holding that petitioner was restricted to the 27-1/2% depletion allowed to the Trust under section 613 when

(a) section 611 has always, since its original enactment in section 204(c)(2) of the Revenue Act of 1926, expressly provided:

> "In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section";

(b) the evidence is uncontradicted that on the basis of 27-1/2% depletion petitioner will never recover through such allowance his basis of $37 a share; and

(c) the evidence is uncontradicted that it is utterly impossible for petitioner to arrive at any figure for computing his cost depletion on 6152/192,500 of the income of the Trust from scattered royalties in 36 oil and gas fields in 6 states? Such a holding is in conflict with *Burnet v. Logan*, 283 U.S. 404, and with *Commissioner of Internal Revenue v. Tellier*, 383 U.S. 687, and cases cited therein that fundamentally the income tax law is to be applied so as to tax net income and not gross income.

2. Were the courts below correct in holding that petitioner is not entitled in reference to his shares in the Trust and through it his shares in Trinity Petroleum, Inc., to any deduction under section 167 of the Internal Revenue Code for the exhaustion of those shares, which are held for the production of income? This is contrary to the provisions of section 167 and *New York Life Insurance Co. v. Anderson*, 263 Fed. 527, holding that stock in a corporation is subject to an allowance for its exhaustion.

3. Were the courts below correct in holding that, because the market for shares in the Trust has been above petitioner's basis of $37 per share, petitioner's allowance for deductions is to be restricted to the 27-1/2% depletion allowed the Trust? Such a holding is entirely in conflict with *Fribourg Navigation Company, Inc. v. Commissioner of Internal Revenue*, 383 U.S. 272, and *Even Realty Co.*, 1 B.T.A. 355.

STATUTES INVOLVED

The applicable statutes are sections 167(a), 611 and 613 of the Internal Revenue Code as set forth in Appendix C hereto, page 35.

STATEMENT

The Court of Appeals stated per curiam that it agreed with the District Court's statement of the legal principles involved in this case. We will, therefore, deal with the opinion of the District Court. As that court's statement of the case was so inaccurate, we ask this Court to consider our own statement, which is amply supported by the record.

In 1937 Sherar and two others, who were oil men, formed Trinity Petroleum Company to buy oil and gas royalties. Sherar was the president, Beatty was the geologist, and petitioner was its attorney. From 1946 petitioner was its president and actively ran it. In 1951 it was desired to liquidate the Company and place the royalties in a trust. The Company's royalties were in 36 fields in Texas, Louisiana, Arkansas, Illinois, Indiana and Oklahoma. Their complexity is shown by petitioner's Exhibit No. 1 and the 20 maps attached thereto and the statement therein by petitioner, it being agreed that his statement would be accepted as testimony. (R. 70) Nine copies of that exhibit are filed with this Court. However, in Louisiana a trust could continue for only 10 years. A plan was worked out with the Government under which the Company organized Trinity Petroleum, Inc., a Texas corporation, with a small capital of 1,985. (R. 27-28) The Louisiana royalties were transferred to Trinity Petroleum, Inc., and the latter contracted to pay 95% of its income to the Company. (R. 35-39) On October 1, 1951, the Company transferred to the South Texas National Bank of Houston as Corporate Trustee, all the royalties in Texas, the stock of Trinity Petroleum, Inc., and its rights under the 95% contract. It transferred its royalties in the other four states to Arthur Trum, Individual Trustee, a trust officer of the

Bank, whose functions were merely to hold title to the royalties with the income going to the Corporate Trustee. The Bank as Trustee executed an Indenture of Trust under which it held all the property. The trust is generally referred to as the Trinity Petroleum Trust. The Company had 192,500 shares and it distributed to its stockholders the 192,500 shares in the Trust, with petitioner and his then wife receiving 6,152 shares.

The Commissioner by letter dated July 31, 1951, (R. 40-49) ruled (1) that the Trust would be taxable as a trust and not as an association, (2) that the 95% of the income from the Louisiana royalties paid by Trinity Petroleum, Inc., to the Trust would not be taxable to that Company, and (3) the Trust would be entitled to deduct depletion on that 95% income as well as the other royalties owned by the Trust itself.

The Trust Indenture is set out as Exhibit 1 to the pretrial stipulation, (R. 34) and nine copies thereof are filed with this Court. Article II thereof provides

> "No new or additional oil or gas royalties or properties of any other kind shall be acquired by the Trustees."

Paragraph 3 of the contract between Trinity Petroleum, Inc., and the Company (R. 37) provides that Trinity Petroleum, Inc., may not acquire any other properties or engage in any business except the ownership of the properties conveyed to it on October 1, 1951.

Petitioner's wife died in 1959 and bequeathed her half of the community property 6,152 shares to petitioner, and her shares were valued for estate tax purposes at $37 per share, which made petitioner's basis under section 1014 for the 6,152 shares $37 per share or $227,624.

Petitioner's suit is to recover income taxes paid by him for 1960, 1961 and 1962 on his income from the Trust. Paragraphs III-5 through III-10 of the complaint (R. 5-10) set out how Trinity Petroleum, Inc., and the Trust made their tax returns and how the taxable income of petitioner upon which he paid the taxes in controversy was determined. The facts set forth in those paragraphs are admitted by respondent's answer or in the stipulation. (R. 15 and 33) This may be illustrated as follows by using 1960.

Trinity Petroleum, Inc., showed its royalty income, (not including the part paid to the Trust under the 95% contract) deducted 27½% depletion and its expenses and paid Federal income tax on the balance. It had net cash for the year of $24,634.01 and paid a dividend to the Trust of $23,100 or 12¢ per share on the 192,500 shares.

The Trust showed that dividend and its royalties, deducted 27½% depletion on the latter and its expenses and showed the balance of $459,005.05 as its taxable income which it allocated to its certificate holders as dividend income of 12¢ per share and royalty income of $2.2644 per share. As its depletion deduction was not a cash reduction, it distributed to its certificate holders $648,725 in cash or $23,100 as dividends and $625,625 as royalties.

On the foregoing basis petitioner received for 1960 $738.24 as dividend income and $19,994.00 as royalty income, or a total cash of $20,732.24. However, the Government taxed him on $738.24 dividend income and $13,930.85 royalty income. This was taxation of a total of $14,669.09, which left him out of his cash of $20,732.24 only $6,063.15 to apply on his total basis of

$227,624 for his 6,152 shares. At this rate it would take petitioner 37½ years to recover his basis. Similarly, for 1961 the figure is 33.8 years and for 1962, 27.9 years.

Sherar, Beatty and petitioner all testified that it was impossible to determine any figure for petitioner to use for a cost depletion computation, and further that petitioner would not through the deductions allowed by the Government in this case ever recover his $37 per share tax-free, that is, he would be taxed on part of that $37 per share and would not be taxed upon his net income.

The position of the respondent is concretely stated by its attorney, Mr. Tyler, in the District Court as follows:

> "Mr. Tyler: * * *. Our position is 27½% is the maximum amount. It is our position the Revenue Code provides two methods of computing depletion, through a cost basis or through a percentage basis. Now, Mr. Bruce has alleged in his complaint that it is not possible to determine the total reserves which is necessary to determine cost depletion, so you can't determine it if you have to use percentage.
>
> * * *
>
> "Mr. Tyler: * * *. Now, it is our position that since these shares are traded in the active securities market here in the Houston area Mr. Bruce could have gone out at any time and sold his shares and recovered not only his basis but have made a gain, made a profit. * * *
>
> "Our position is the only deduction or exclusion from income would be the 27½% of the gross royalties." (R. 62-63)

The District Court sustained these positions of respondent and entered judgment denying petitioner any recovery.

REASONS FOR GRANTING THE WRIT

1. The action of the District Court in misinterpreting section 167 providing for reasonable allowance for the exhaustion of property held for the production of income, in holding that the 27½% depletion provision under section 613 is controlling even though the evidence shows that it will not return petitioner's basis, in holding that the general doctrine announced by this Court in *Burnet v. Logan*, 283 U.S. 404, is not applicable because there was a market value for petitioner's shares in the Trust, and in holding that petitioner is restricted to 27½% depletion because he could have sold his shares for more than his basis, contrary to the specific holding of this Court in *Fribourg Navigation Company, Inc. v. Commissioner of Internal Revenue*, 383 U.S. 272, and the case of *Even Realty Co.*, 1 B.T.A. 355, is so erroneous and will have such a far reaching effect on the whole area of law involved that this Court should hear this case and correct those erroneous holdings of the District Court.

Contrary to the statement by the District Court that petitioner relies entirely on *Burnet v. Logan, supra*, petitioner relies on the fundamental proposition consistently promulgated by the Congress and this Court, that the income tax laws are to be interpreted to levy a tax upon taxpayers' net income and not upon their gross income unless the Congress specifically provides to the contrary. This Court as recently as March 24, 1966, in *Commissioner of Internal Revenue v. Tellier*, 383 U.S. 687, said (p. 691):

> "We start with the proposition that the federal income tax is a *tax on net income*, not a sanction against wrongdoing. That principle has been firmly imbedded in the tax statute from the beginning. * * *

"With respect to deductions, the basic rule, with only a few limited and well-defined exceptions, is the same. During the Senate debate in 1913 on the bill that became the first modern income tax law, amendments were rejected that would have limited deductions for losses to those incurred in a 'legitimate' or 'lawful' trade or business. Senator Williams, who was in charge of the bill, stated on the floor of the Senate that

> " '[*T*]*he object of this bill is to tax a man's net income;* that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses.' "

After referring to *Commissioner v. Sullivan*, 356 U.S. 27, *Lilly v. Commissioner*, 343 U.S. 90, and *Commissioner v. Heininger*, 320 U.S. 467, this Court said (p. 693):

"Deduction of expenses falling within the general definition of § 162(a) may, to be sure, be disallowed by specific legislation, since deductions 'are a matter of grace and Congress can, of course, disallow them as it chooses.' *Commissioner v. Sullivan*, 356 U.S., at 28. The Court has also given effect to a precise and longstanding Treasury Regulation prohibiting the deduction of a specified category of expenditures; an example is lobbying expenses, whose nondeductibility was supported by considerations not here present. *Textile Mills Corp. v. Commissioner*, 314 U.S. 326, *Cammarano v. United States*, 358 U.S. 498. *But where Congress has been wholly silent, it is only in extremely limited circumstances that the Court has countenanced exceptions to the general principle reflected in the Sullivan, Lilly and Heininger decisions.*" (Emphasis added)

In *Commissioner of Internal Revenue v. Sullivan*, 356 U.S. 27, this Court in sustaining the right of a gambler

to deduct expenses incurred in conducting illegal gambling, said at page 29:

> "If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, *while all other business would be taxable on the basis of net income. If that choice is to be made, Congress should do it.*" (Emphasis added)

Petitioner has never claimed that he will not receive through income from the Trust his full $37 per share. His position, supported by the uncontradicted evidence in this case, never challenged at any time by the Government, is that (1) the deductions allowed him by the Government will never equal his basis of $37 per share, (2) neither he nor anyone else can come to any figures for his cost depletion, and (3) the Government will be taxing him in part upon his gross income and not upon his net income. These facts have not yet been controverted by the Government and, therefore, we feel it unnecessary to set out in the body of this petition the evidence on those points. However, for the ready reference of the Court, we set it forth in Appendix D hereto, page 36.

Burnet v. Logan, 283 U.S. 404, is in all essential respects identical with this case. There were involved two interests in a contract that called for a mining company to pay 60¢ per ton for all ore mined from a single mine, which contract was owned by a company. Mrs. Logan and her mother sold their stock in the latter company and each received cash and a fractional interest in the 60¢ ton agreement. Mrs. Logan's mother died and left one-half of her interest to Mrs. Logan, which one-half was valued in her mother's estate at $277,164.50 for estate tax pur-

poses. Mrs. Logan claimed that it was so indefinite as to what she would receive under the 60¢ per ton agreement that she was entitled to recover her basis in the stock of the company sold as to her first interest and the estate valuation of $277,164.50 as to the interest inherited from her mother, before being held to have received any taxable income. This Court held with her on both points. The Government introduced detailed estimates as to what she would recover and what percentage would represent taxable income, but this Court rejected all of this evidence. In the present case the Government did not even attempt to furnish any such estimates. As to the interest inherited from her mother, which is exactly like the interest that petitioner has in these shares in the Trust, this Court said on pages 413-414:

> "From her mother's estate Mrs. Logan obtained the right to share in possible proceeds of a contract thereafter to pay indefinite sums. The value of this was assumed to be $277,164.50 and its transfer was so taxed. *Some valuation—speculative or otherwise—was necessary in order to close the estate.* It may never yield as much, it may yield more. If a sum equal to the value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment. We think a like rule should be applied here." (Emphasis added)

The rule in *Burnet v. Logan* has been specifically held by the Government to be applicable to oil and gas royalties,[1] and there are many cases applying the rule.[2]

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1. G.C.M. 9798, X-2 C.B. 221; G.C.M. 11473, XII-1 C.B. 91; G.C.M. 11822, XII-1 C.B. 229.

2. Among which cases see **Helvering v. Drier**, 79 F.2d 501 (4 CCA); **Axe v. United States**, 191 F.Supp. 671; **Inaja Land Company, Ltd.**, 9 T.C. 727; **Anton L. Trunk**, 32 T.C. 1127. See **Mertens Law of Federal Income Taxation**, § 5.02, pp. 22-23, Footnote 71.

The only place where market value came into play in *Burnet v. Logan* was in connection with the first situation cited above where Mrs. Logan sold some of her shares and got cash and an interest in the 60¢ per ton royalty agreement. This Court said that in such a case she would be entitled to recover her basis before having any tax *because this was not a closed transaction since there was no market for the interest in the 60¢ per ton royalty that she received.* This Court said at page 413:

> "Nor does the situation demand that an effort be made to place according to the best available data some approximate value upon the contract for future payments. This probably was necessary in order to assess the mother's estate. As annual payments on account of extracted ore come in they can be readily apportioned first as return of capital and later as profit. *The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation.* When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000.00 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. *It has no ascertainable fair market value. The transaction was not a closed one.*" (Emphasis added).

Commissioner of Internal Revenue v. Carter, 170 F.2d 911, is the only type of case where market value comes into play. A corporation with a large number of brokerage contracts calling for payment to it of 1¢ per barrel on all oil to be sold to various parties under certain contracts, was dissolved by the sole stockholder, who received its rights to these brokerage payments. The court held on the strength of the above statement in *Burnet v. Logan*

that, since the brokerage contracts had no ready market value, *the liquidation was not a closed transaction* and all the money the stockholder would receive thereafter on the brokerage contracts would be on the basis of capital gains.[3] On the other hand, if they had had a ready market value and it had exceeded the stockholder's cost of the stock, such excess would have been taxed as a capital gain and the receipts thereafter under the brokerage contracts would have been ordinary income. Therefore, it is clear that under *Burnet v. Logan* the fact that there was a market value for petitioner's shares in the Trust has no bearing upon the present case.

But both the Government and the District Court say that the provision for 27½% depletion under section 613 is the complete answer and by it Congress intended to resolve all these uncertainties. For example, the District Court said:

> "Production from a single oil or gas well presents much the same difficulties of capital-income allocation as does Trust's 'many, many tracts in 36 fields in 6 different states.' The difficulties are both technical (how much oil reserve exists) and conceptual (whether the production of oil is a mere conversion of capital investment or an income producing operation). Congress resolved these difficult problems by providing the 27½% depletion allowance; 27½% of the oil or gas produced is not subject to taxation. The figure is arbitrary and represents a concession to the capital conversion aspects. (R. 109)
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> * * *

3. Similar cases on such sales or liquidations are **Westover v. Smith**, 173 F.2d 90 (9 CCA); **McDonald v. United States**, 181 F. Supp. 332 (Washington); **Estate of Raymond T. Marshall**, 20 T.C. 979; **J. C. Bradford**, 22 T.C. 1057; **George J. Lentz**, 28 T.C. 1157; and **Frank H. Hoy**, 17 T.C.M. 115. The Commissioner has acquiesced in the **Carter** case. Rev. Rul. 58-402, 1958-2 C.B. 15.

> "However, plaintiff disputes something different, whether 27½% depletion will ever reduce his basis to zero. This does not bring Logan into play and only speaks to the proper apportionment of capital return and income. Plaintiff asserts that this alleged uncertainty entitles him to treat all revenues as returns of capital until he recovers his basis. Section 613 provides that this uncertainty is resolved by the arbitrary allocation of 72½% income, 27½% principal." (R. 110)

The slightest knowledge of section 613 and its history refutes the position of the Government and of the District Court. In Appendix E hereto we set out the history of the provisions dealing with depreciation and depletion. The 27½% depletion was enacted for the first time in the 1926 Act and, as shown in Appendix E hereto, p. 43, section 204(c)(2), providing for the 27½% depletion, expressly stated

> "except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

As shown in that appendix, the report of the Senate Finance Committee on the 1926 Act stated that it was enacted merely to get around the difficulty of administering the discovery provisions dealing with depletion. It stated:

> "The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration your committee recommends that in the case of oil and gas wells the allowance for depletion shall

> be 25 per cent of the gross income from the property during the taxable year."

In the conference this was raised to 27½%.

In the regulations under the 1926 Act, the Commissioner said in Regulations 69, Art. 1602(2), providing for the 27½% depletion:

> "In no case shall the deduction for depletion with respect to oil and gas wells be less than it would be if computed without reference to section 204(c)(2) of this paragraph."

Section 611 provides that there shall be allowed a reasonable allowance for depletion. Section 613 dealing with percentage depletion provides that the allowance under section 611 shall not be less than it otherwise would be if section 613 were not in the law.

It is clear that petitioner is not limited to the depletion of 27½% taken by the Trust on its royalty income.

2. Petitioner claims that in addition to the depletion allowance under section 611 and the rule under *Burnet v. Logan*, he is expressly allowed a deduction under section 167 for the exhaustion of his shares in the Trust and of his indirect interest in the shares in Trinity Petroleum, Inc. As shown in Appendix C hereto, page 35, section 167 allows the deduction for the exhaustion of property held for the production of income. Prior to 1942 and the decision by this Court in *Higgins v. Commissioner of Internal Revenue*, 312 U.S. 212, such a deduction for exhaustion could be taken only for property used in a trade or business. Congress by section 121 of the Revenue Act of 1942 extended this provision to "property held for

the production of income." Certainly the shares in the Trust and petitioner's indirect interest through the Trust in shares in Trinity Petroleum, Inc., are held for the production of income.

The District Court missed the entire point under section 167 when it stated (R. 110):

> "Plaintiff also complains that he is allowed no depletion on his receipts from the dividends of Inc. *Inc. is allowed depletion on its royalties.* Plaintiff cites no authority that a shareholder is entitled to depletion or depreciation of any kind on the assets of a corporation, * * *." (Emphasis added)

Petitioner, of course, has never claimed he is entitled to any depletion or depreciation in reference to the assets of Trinity Petroleum, Inc., but he does assert he is entitled to a deduction for the exhaustion applicable to his indirect stock interest in Trinity Petroleum, Inc. As pointed out above, neither the Trust nor Trinity Petroleum, Inc., may acquire any properties other than those conveyed to them on October 1, 1951, at their creation. Their assets consist of oil and gas in the ground which is being exhausted. However, with reference to the income from dividends on the stock of Trinity Petroleum, Inc., the Government is taxing petitioner on all of those dividends with no deduction whatsoever. On that basis, petitioner will pay income taxes on all his receipts of those dividends and never recover any part of his basis applicable to them.

The District Court apparently put great emphasis on the fact that Trinity Petroleum, Inc., was allowed depletion on its income for it said, as above shown:

> "Inc. is allowed depletion on its royalties."

The fact that Trinity Petroleum, Inc., is allowed the depletion is of no benefit to petitioner. It merely increases the dividends that he would otherwise receive but does not allow him any deduction on account of those dividends.

In the minds of some it seems that they think that depreciation allowances apply only to physical properties. This is completely wrong. For example, as early as Regulations 69 under the Revenue Act of 1926, Art. 163 provided

> "Art. 163. Depreciation of intangible property—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance."

As early as 1925 the Board of Tax Appeals pointed out that the word "depreciation" disappeared from the Revenue Acts after that of 1913.[4]

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4. In **Even Realty Co.**, 1 B.T.A. 355 (1925), the Board said at page 361:

"But it should be noted that the word **depreciation** has disappeared from the revenue acts. Presumably the change was made by Congress in an effort to perfect the language of the statute. The act of 1909 said 'a reasonable allowance for depreciation of property, if any.' The Revenue Act of 1913 restricted the deduction to an allowance for depreciation **by use, wear, and tear.** And the later revenue acts eliminated the word **depreciation** entirely (see p. 359, **supra**). There is nothing in any of the revenue acts subsequent to the Sixteenth Amendment which would have precluded the taxpayer from taking a reasonable deduction for **wear and tear** upon its building, even though the building itself might have appreciated in value at the same time.

"Depreciation in its broad sense, like appreciation, may be due to extrinsic causes, but that is not true of **wear and tear.** There is no reason why **wear and tear,** purely intrinsic matters, need be tied up to **appreciation** resulting from extrinsic causes. The two can go on simultaneously and no provision of law requires the one to be offset against the other. The

In reference to the statement of the District Court that no case has ever held that a stockholder was entitled to a deduction for exhaustion of stock in a corporation, the Court of Appeals for the Second Circuit as early as January 14, 1920, in *New York Life Insurance Co. v. Anderson*, 263 Fed. 527, held that taxpayers who own stock in corporations may take deductions for their depreciation. Petitioner cites that case only to show that it has been held that stock in corporations may be exhausted and the holder is entitled to a deduction on account thereof, but frankly petitioner doubts that this Court would apply the method in computing this exhaustion followed by the court in the case cited.

3. The District Court's holding adverse to petitioner on the ground that there was a market for his shares in the Trust greater than his basis is directly in conflict with *Fribourg Navigation Company, Inc. v. Commissioner of Internal Revenue*, 383 U.S. 272. (As the *Fribourg* case was decided March 7, 1966, and the District Court decided this case on February 2, 1966, it did not have the advantage

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revenue acts do not contemplate the annual computation of appreciation for the purpose of taxing the increase of value represented thereby—they expect appreciation to be accounted for entirely and exclusively at the final disposition of the property. **This is quite logical, for an appreciation due to extrinsic circumstances, such as general market changes, is very likely to be offset by a corresponding reduction in value because of similar extrinsic causes in a later period,** while the property is still held by the same owner; and it would obviously be highly inconvenient if not impossible, as well as unfair, to require every taxpayer to appraise all his capital assets at the end of every year for the purpose of seeing whether there were any net appreciation in value during the year and of taxing him thereon. But **exhaustion** and **wear and tear** are due wholly to intrinsic causes—the nature of the asset. They are not offset by any other intrinsic causes." (Emphasis added)

of this Court's opinion in the *Fribourg* case and that probably accounts for its decision being in conflict with the rule announced by this Court in that case.)

The District Court said (R. 111):

> "The market prices also perform a second and distinct role. They provide a means by which plaintiff can certainly recover his basis. Plaintiff can sell his shares."

The District Court in that decision went directly contrary to the fundamental statement by this Court in the *Fribourg* case:[5]

> "By tying depreciation to sales price in this manner, the Commissioner has commingled two distinct and established concepts of tax accounting—depreciation of an asset through wear and tear or gradual expiration of useful life and fluctuations in the value of that asset through changes in price levels or market values."

It is interesting to note that the Board of Tax Appeals as early as 1925 in *Even Realty Co.*, 1 B.T.A. 355, pointed out the fundamental difference between depreciation and appreciation as shown by the quotation from that Board's opinion in Footnote 4, page 18 hereof. It shows the fundamental error into which the District Court fell in this case in deciding it against the petitioner on the basis of this so-called market value.

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5. Just contrary to the action of the District Court in this case the **Fribourg** case has been widely followed by other courts. **Sheppard v. U. S.**, 361 F.2d 972 (Ct. of Claims); **U. S. v. Kimball Gas Products Co.**, 358 F.2d 133 (5 CA); **U. S. v. Wyoming Builders, Inc.**, 358 F.2d 672 (10 CA); **Shepherd v. U. S.**, 66-1 U.S.T.C. ¶9458 (Dist. Ct. Ala.); **John Town, Inc.**, 46 T.C. 107; **Catherine F. Dinkins**, 45 T.C. 593.

CONCLUSION

Petitioner suggests that there is one simple answer to the position of the District Court and the Court of Appeals that the 27½% depletion provision is absolutely controlling. As is well known, there has been for many years a concerted attack on the figure of 27½%. Many opponents propose to reduce it to 10%, but let us suppose that the figure had always been 15% instead of 27½%. On the basis of 15% petitioner's income from the 6,152 shares would have to total $1,517,493.33 for him to recover his basis of $227,624, which would mean that the total production from the Trust royalties would have to be $47,483,333.18, which figure is, of course, ridiculous to contemplate. Yet, we do not know but what the depletion percentage will be reduced to 15% or even less.

Petitioner respectfully prays that this petition for writ of certiorari be granted.

Respectfully submitted,

HOMER L. BRUCE
Pro Se
1600 Esperson Building
Houston, Texas 77002

APPENDIX A

IN THE

United States District Court

SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

CIVIL ACTION NO. 65-H-30

HOMER L. BRUCE, Plaintiff,

v.

UNITED STATES OF AMERICA, Defendant.

Memorandum:

On January 15, 1965, plaintiff, Homer L. Bruce, filed suit against the United States of America for the refund of income taxes paid under protest by plaintiff for the years 1961, 1962 and 1963. Stipulations of fact were filed by the parties and plaintiff introduced additional evidence at a trial held on November 22, 1965. The question is whether plaintiff need pay income taxes on funds received by him from the Trinity Petroleum Trust prior to the time the total payments exceed his basis in the Trust. This court holds that plaintiff must pay income taxes, subject only to the statutory depletion allowance.

The following facts are taken from the stipulations of fact filed by both parties. Trinity Petroleum Company,

hereinafter "Company", owned various oil and gas royalties in five states. Company organized Trinity Petroleum, Inc., hereinafter "Inc.", and on October 1, 1951, conveyed all its royalties to Inc. in exchange for 95% of all income received by Inc. from these royalties. Profits received on the other 5% would go to Company as Inc.'s sole owner should dividends be paid.

This same day Trinity Petroleum Trust, hereinafter "Trust," issued its 192,500 shares of beneficial interest to Company. Company distributed these shares in Trust to Company's shareholders in return for their 192,500 shares of Company.

These transactions left the following situation: Inc. held all the royalties. 95% of Inc.'s royalty revenue went directly to Trust. Any dividends declared by Inc. on the other 5% of its revenues also went to Trust.

Internal Revenue has insisted upon the following treatment of these proceeds: (1) Inc. passes 95% of its royalty income to Trust without taxation consequence. From the 5% it retains, Inc. deducts taxes paid, expenses, and 27½% *depletion* to compute its taxable income. (2) Trust deducts from its total receipts from Inc. taxes paid, expenses, and 27½% *depletion* on the 95% of royalties to compute taxable income. Insofar as Trust pays out to its shareholders an amount greater than taxable income, it pays no taxes. (3) The holder of shares of beneficial interest in the trust divides his receipts into three categories. That portion corresponding to Inc.'s dividends to Trust is taxable as ordinary income, depletion already having been allowed Inc. The remainder corresponds to the 95% paid directly to Trust by Inc. The share holder reports as ordinary income his portion of Trust's *taxable income* from the royalties. The

remainder is not taxable and it corresponds roughly to the depletion allowance claimed by Trust.

Plaintiff and his wife held as community property 6,152 shares of beneficial interest in Trust. Upon the death of plaintiff's wife on October 14, 1959, plaintiff became the sole holder of these shares. They were valued at $37 per share for federal estate tax purposes, and under Section 1014 of the Internal Revenue Code, $37 per share is now plaintiff's basis for all 6,152 shares.

Plaintiff received payments from Trust in 1961, 1962 and 1963 roughly totaling his proportionate share of all Trust's income in these years. Plaintiff did not include any of these proceeds in his income tax returns as taxable income. Plaintiff was subsequently assessed deficiencies as outlined above: (1) income corresponding to Inc.'s dividends to Trust taxable in full; (2) income corresponding to Trust's other *taxable* income taxable in full; (3) additional amounts corresponding to Trust's allowance for depletion not taxable. Plaintiff paid these assessments and instituted the present suit for refund.

I.

Plaintiff's basic position relies upon the Supreme Court case of Burnet v. Logan, 283 U.S. 404 (1931). The Supreme Court there held that when it is impossible to determine with fair certainty the fair market value of property held for the production of income, the owner may consider all returns to be returns of capital until he recoups his basis. After that, all sums received are ordinary income.

Plaintiff seeks to bring himself within this rule. He and his witnesses maintain that it is impossible to ascertain the value of the many royalties held by Inc., "many, many

tracts in 36 fields in 6 different states." Because Inc. does not have the power to acquire new leases, plaintiff claims it impossible to establish that his basis will ever be realized via the depletion allowances he now enjoys. There is opinion testimony that he never will recover his basis. At the rate of depletion allowed in the years in question, it would take over thirty years of similar production for the allowance to total up to his basis. With no new leases, plaintiff claims future production will decline.

From these facts and opinions, plaintiff concludes that recovery of his basis is far less certain than it was in the Logan case. There the taxpayer held the right to receive a specified interest in 60¢ per ton to be paid upon the extraction of ore from a mine. The future payment price, 60¢, was certain, and there was only one mine, containing non-fugitive minerals. Yet the Supreme Court said:

> "She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture." Burnet v. Logan, supra, 413.

Plaintiff maintains that the "conjecture" necessary in the Logan case is only slight compared to that necessary to value Inc.'s royalties. Consequently, he should pay no tax until his full basis of $37 per share is realized.

II.

Plaintiff has failed to establish the requisite uncertainty necessary to bring him within the Logan rule. A central factor relied upon by the Supreme Court was that it could not foretell with anything like reasonable certainty that the taxpayer would recover her capital investment.

> "Respondent might never recoup her capital investment from payments only conditionally promised." Burnet v. Logan, supra, at 413.
>
> "Some valuation—speculative or otherwise—was necessary in order to close the estate. It may never yield as much, it may yield more." Burnet v. Logan, supra, at 413-14.

The latter quotation was followed by an important analogy:

> "If a sum equal to the value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment." Burnet v. Logan, supra, at 414.

Certainly the distinguishing point about an annuity contract is that one never knows if the holder will live long enough to recoup his capital investment. The prospect of receiving income or interest is most uncertain. (It is interesting to note that despite this uncertainty, the Code *today* requires certain annuity payments to be apportioned between return of capital and income according to actuarial statistics. See Section 72 of the Internal Revenue Code.)

The Court of Appeals for the Sixth Circuit recently stated the rule of Logan to be:

> "Determination of the issue (whether income taxes are due before capital investment is recouped) turns on the question of whether the investment . . . is of such a speculative nature that the purchaser . . . cannot be reasonably certain of ever recovering his cost (citing Burnet v. Logan)." Darby Investment Corp. v. Commissioner, 315 F.2d 551, 552 (C.A. 6th, 1963).

Plaintiff cites two federal cases illustrating applications of Logan. Both cases strongly reinforce the crucial role in Logan of the certainty of return of capital. In Helvering v. Drier, 79 F.2d 501 (C.A. 4th, 1951), the taxpayer had been awarded damages plus interest, the annual payments of which were conditioned upon annual receipt by the United States of war debts from Germany. The court refused to consider any portion of payments made to be payments of interest (and thus taxable income) until plaintiff received the principal sum due.

> "Hence it has been doubtful ever since the award of 1929 was made whether the taxpayer ever would receive payment thereof in full. Under these circumstances, we agree with the Board that the case is governed by the rule in Burnet v. Logan . . ." Helvering v. Drier, supra, at 503.

In the second case relied upon by plaintiff, Axe v. United States, 191 F.Supp. 671 (D.Kan., 1961), the court applied the Logan rule because there was uncertainty as to whether any payment, capital or income, would ever be made.

In summary, Logan and subsequent cases clearly establish that before income taxes will be deferred until capital has been recouped, there must be uncertainty as to whether the taxpayer's basis will ever be recovered. Plaintiff's basis for his shares of beneficial interest in Trust is $37 per share. It is stipulated that plaintiff has received the following per share payments from Trust:

1960	$ 3.37
1961	3.755
1962	4.58
1963	4.97
1964	5.15

Payments for the five year period total $21.825 per share, well over one-half plaintiff's basis in the shares. The amount has increased each year. From these facts and the detailed information about the royalties presented to this court, this court holds that there is strong reasonable certainty that plaintiff will recoup his basis in the shares.

Plaintiff introduced evidence at the trial that he will never recoup his basis *through the deductions presently allowed plaintiff*. Plaintiff has at no time maintained that any uncertainty exists as to whether he will recoup his basis in the shares. The contention which plaintiff does advance relates to the function of the depletion allowance.

The deductions presently allowed plaintiff are essentially Trust's depletion allowance of 27½% on the 95% royalties it receives from Inc. Each year plaintiff excludes from taxable income an amount roughly corresponding to his proportionate share of Trust's depletion deduction and deducts it from his basis. This amount for plaintiff per share was:

1960	$ .99
1961	1.09
1962	1.32
1963	1.44
1964	1.50

The five year total was $6.34 and the amount has increased each year. At the average rate of $1.27 per year experienced in these five years, it would take plaintiff 24 more years to reduce his basis to zero. Plaintiff and his witnesses maintain this will never happen. In reality, plaintiff maintains that the 27½% apportionment is insufficient.

This court by no means accepts plaintiff's predictions. No holding on the matter is required, because Congress has

resolved such matters by the 27½% depletion allowance. Section 613 of the Internal Revenue Code.

Production from a single oil or gas well presents much the same difficulties of capital-income allocation as does Trust's "many, many tracts in 36 fields in 6 different states." The difficulties are both technical (how much oil reserve exists) and conceptual (whether the production of oil is a mere conversion of capital investment or an income producing operation). Congress resolved these difficult problems by providing the 27½% depletion allowance; 27½% of the oil or gas produced is not subject to taxation. The figure is arbitrary and represents a concession to the capital conversion aspects. Anderson v. Helvering, 310 U.S. 404, 406 (1940). It does not purport to reflect the precise or even closely approximate percentage of production which is capital conversion in a single tract, a thousand tracts, or even in the entire petroleum industry. It reflects only the existence of a capital conversion element in an arbitrary, but time-honored amount.

Certainly a taxpayer is not limited to the 27½% depletion figure. He may, for example, use cost depletion under Section 612 of the Internal Revenue Code. However, plaintiff seeks to escape the limitations of the 27½% depletion allowance by pointing to the very uncertainties which it exists to resolve. If plaintiff were to establish that it is uncertain as to whether he will ever recoup his basis, then Logan might apply and supplant depletion. However, plaintiff disputes something different, whether 27½% depletion will ever reduce his basis to zero. This does not bring Logan into play and only speaks to the proper apportionment of capital return and income. Plaintiff asserts that this alleged uncertainty entitles him to treat all revenues as returns of capital until he recovers his basis. Section 613 provides

that this uncertainty is resolved by the arbitrary allocation of 72½% income, 27½% principal.

Thus, Section 613 resolves difficulties of apportionment similar to those which called the Logan rule into play in the case of Inaja Land Company, Ltd., 9 T.C. 727 (1947), and Anton L. Trunk, 32 T.C. 1127 (1959).

Plaintiff also complains that he is allowed no depletion on his receipts from the dividends of Inc. Inc is allowed depletion on its royalties. Plaintiff cites no authority that a shareholder is entitled to depletion or depreciation of any kind on the assets of a corporation, nor has plaintiff pointed to a single instance where the Logan rule has been extended to a shareholder due to uncertainties concerning a corporation's assets.

III.

There is an additional fact which clearly demonstrates that plaintiff is not within the Logan rule. Shares of beneficial interest in Trust are regularly bought and sold "over-the-counter" through various brokers. Since 1959 the low for such shares has always been greater than plaintiff's basis of $37 per share. The high and low bid prices were:

	1960	1961	1962	1963	1964	9/15 1965
Low	38	49	52	58	83	91
High	45	52	58	83	96	96

Recent selling prices more than twice plaintiff's basis clearly reflect a virtual certainty that plaintiff will recover his basis by holding the shares of beneficial interest. They further tend to indicate that plaintiff will recoup his basis through depletion as well (a question which this court does

not decide). This is because market price is a form of valuation of the thing itself. These high market prices reflect the degree of certainty that plaintiff will receive payments in the future which will exceed his basis.

The market prices also perform a second and distinct role. They provide a means by which plaintiff can certainly recover his basis. Plaintiff can sell his shares. Of course, plaintiff is not required to sell his shares. This second point is that plaintiff has at hand a certain means of recovering his basis, which defeats the rule of Logan.

Courts have not always distinguished these two roles of market value—reflection of value and alternative means of recovering basis. However, the existence of a certain market value in excess of basis has always been held to remove the uncertainties relied upon in Logan.

In Chamberlin v. Commissioner, 286 F.2d 850 (C.A. 7th, 1960), cert. denied 368 U.S. 820 (1961), the court required that patent royalties be reported as ordinary income. Though the court relied on the view that Logan hinged on uncertainty as to return of capital (see part II of this opinion), not on a lack of ascertainable value, it found the sale of only twelve shares of stock in sixteen months to help establish ascertainable value. By contrast, as many as 8,514 shares in Trust have been sold in a single year.

In Darby v. Commissioner, supra, existence of a market value was heavily relied on to show that the taxpayer was reasonably certain to recover his investment. Two cases applying Logan were distinguished. In Phillips v. Frank, 295 F.2d 629 (C.A. 9th, 1961), the court said:

> "There is no evidence in the record that such rights had any market value . . . or any other value in excess

> of taxpayer's cost. There is no evidence in the record that taxpayer at any time could have sold such contracts at a profit. *The only source* from which he might reasonably expect to realize any part of his profit is from periodic payments subsequent to the return to him of his invested capital . . . A return of capital is not income." (emphasis supplied) Phillips v. Frank, supra, at 633-4.

The court relies here on market value as an alternative means of recovering capital which, if present, would defeat the application of Logan.

The second case distinguished was Willhoit v. Commissioner, 308 F.2d 259 (C.A. 9th, 1962). The court refused to hold that the taxpayer would probably realize more than his investment, noting that there was no market for the contracts involved.

In summary, the existence of a ready market price far above plaintiff's basis defeats the application of Logan in two ways: it establishes a virtual certainty that plaintiff will recover his basis through ownership of the shares, and it provides an alternative, certain means by which plaintiff can recover his basis. Even without consideration of this high market price, the evidence is sufficient to establish that the uncertainties relied upon in Logan are not present in plaintiff's situation.

Capital gain or loss is usually determined by liquidation.

Judgment will be entered for defendant. Clerk will notify counsel to draft and submit judgment accordingly.

JOE INGRAHAM
United States District Judge

APPENDIX B

United States Court of Appeals

FOR THE FIFTH CIRCUIT

October Term, 1966

No. 23,642

D. C. Docket No. 65-H-30-Civil Action

HOMER L. BRUCE, Appellant,

v.

UNITED STATES OF AMERICA, Appellee.

Appeal from the United States District Court for the Southern District of Texas.

Before TUTTLE, Chief Judge, AINSWORTH and DYER, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Southern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

January 10, 1967

Issued as Mandate:

APPENDIX C

STATUTES INVOLVED

SEC. 167. DEPRECIATION.

(a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business or

(2) of property held for the production of income.

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) GENERAL RULE.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *"

SEC. 613. PERCENTAGE DEPLETION.

(a) GENERAL RULE.—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). *In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.* (Emphasis added.)

(b) PERCENTAGE DEPLETION RATES. — The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

APPENDIX D

EVIDENCE AS TO THE PROPERTIES INVOLVED

We call the attention of the Court first to petitioner's Exhibit No. 1 (R. 70). The original and nine copies are on file with this Court. It was stipulated that petitioner would be considered as having testified to the facts set out therein (R. 70). That exhibit takes up every one of the properties held by the Trust or Trinity Petroleum, Inc. The maps in that exhibit show in green the tracts in the various fields on which the royalties are located. The major portion of them is approximately a 1/72 overriding royalty on leases 192 and 193 from the State of Louisiana on certain of its waterways, including some of its properties out to the three mile limit in the Gulf of Mexico. That exhibit shows that the state leases referred to as "water bottoms" comprise the greatest part of the properties. Petitioner prepared a statement showing the income for 1960, 1961 and 1962 of the Trust and Trinity Petroleum, Inc., from the various classes of properties involved and it was introduced as Exhibit 2 (R. 74). The original and nine copies of Exhibit 2 are on file with the Court. It shows the following as to the percentage of the production from the properties:

	1960	1961	1962
Water Bottoms	88.094%	89.553%	89.370%
Other Louisiana	6.757	6.000	6.791
Texas	3.501	3.115	2.584
Others	1.648	1.332	1.255
	100.000%	100.000%	100.000%

In reference to those Louisiana properties petitioner testified (R. 74-75):

"Mr. Bruce: We offer that exhibit as Exhibit No. 2.

"Since they were of such importance, and I want to find out what I can do about getting an estimate of those, I went to the Gulf Oil Corporation in Louisiana, to Mr. Roy Payne, and he was in charge of all the Louisiana operations. Now, one of the fields over there is on the west, known as the West Bay Field. Now, Trinity Petroleum Company had an overriding royalty which Mr. Stuart Sherar negotiated, giving the one-seventy second overriding royalty on State Leases Number 192 and 193 from the State of Louisiana on waterways. Now, those go out three miles out into the Gulf and they are along navigable rivers, but it is extremely difficult to find out what is covered by water and what is covered by land. For instance, if water is a certain depth that has land there, two inches of water, that is land. Now, in the West Bay Field that was covered by Lease Number 192 and the adjoining land was under lease to Tidewater Oil Company. I knew of the unitization agreement that had been made between the Gulf Oil Corporation and the Tidewater, and I talked to Mr. Payne about it and he showed me this unitization agreement made about three years ago, and that shows that that unitization agreement covers 16 sands and the sands do not go over the whole field, and they were divided into 82 units and 363 tracts.

"Now, I asked Mr. Payne how much oil was in there. He said, 'Oh, Mr. Bruce, we took our organization four years to work this up, this information up,' and said, 'We don't know how much oil is there.'

* * *

"Mr. Bruce: Your Honor, on that, I put that in to show why when my investigation among people that are in the oil business, as to how I can go about getting an estimate. Mr. Payne in his verbal statements to me said that it did take them four years, and he said it would cost $500,000.00 to make an estimate of the oil.

> Under those circumstances I didn't even try. But to show the complications, I'm going to offer this unitization agreement as Plaintiff's Exhibit No. 3."

That Exhibit No. 3 is a unitization agreement of the West Bay Field in Plaquemines Parish, Louisiana, consisting of a 17 page contract, 16 pages of maps, and 82 pages of statistics on 16 sands and 329 tracts. The original is filed herewith but because of its length nine copies are not filed.

One of the biggest fields covered by lease 192 was in Timbalier Bay. We call attention to petitioner's Exhibit 4 (the original and nine copies of which are on file with the Court) and the lease arrangement and location of the wells as shown on page 128. The Court admitted that exhibit (R. 78). In addition in reference to that Timbalier Field Beatty, the Company's geologist, testified that there were over 480 different sands in the Timbalier Field and in reference to making an estimate he stated (R. 95):

> "In order to work these properties, make an estimate, it would take a number of years to do it. For instance, in the case of Timbalier with over 480 sands, your estimate for it, simply the calculations, would be approximately a day for each sand, and that would be most in working out the structure of the field; and it would take the other fields a proportionate length of time, it would be an inordinate amount of time, and when you get your answer it would be incorrect because of changing conditions."

Petitioner was the last president of Trinity Petroleum Company and has been attorney since then for the bank that is trustee under the Trust. He has received monthly statements from the Bank showing the income from the various properties and the date of the first runs from each. Exhibit 6 to the pre-trial stipulation (R. 34 and 56) is a

tabulation prepared by him of the production from each field by the Company up to January 1, 1952, and by Trinity Petroleum, Inc. and the Trust from that time through 1964. This shows that most of the fields have been in production since around 1938 or the early nineteen-forties. He testified (R. 83) that eight of the royalties had long since played out and ceased to produce and further testified that in his opinion he would never recover his $37 per share on the deductions being allowed him by the Government. (R. 78-79).

Sherar testified that he had been an engineering student at the University of Colorado and started out with an oil company in 1924 as a research geophysicist and in 1934 became the chief geophysicist of Carter Oil Company. He resigned in 1937 and was one of the organizers of Trinity Petroleum Company and as its president attended with Beatty to the purchase of all these properties (R. 84-85). He testified that he was thoroughly familiar with the above mentioned Exhibit No. 6 covering the production of all the properties. He stated that he had heard petitioner's testimony during the trial of this case.

He testified (R. 87):

> "Q. Do you think in your opinion as an expert would I get my $37.00 back?
>
> "A. I think, in analyzing a thing of this kind you've got to take into account the length of production. This is a factor that any buyer of royalties, which I am from my own account would take into account, that *I would say the answer is no.* (Emphasis added).
>
> "Q. Mr. Sherar, what was your opinion as to the ability of anyone to make a reasonably accurate estimate as to how much oil and gas would be produced from these properties if I attempted to compute my depletion on a cost basis?

"A. Mr. Bruce, I doubt very seriously that anyone would have the data or if they had the data would be able to analyze that. That is a continuing problem because these things change from time to time. I would think they would not be able to make a good evaluation of all these properties."

Beatty, whose testimony is set out in R. 91-98, testified that he had been a geologist all of his business life, that he had been the geologist for Trinity Petroleum Company and was familiar with these properties and in 1948 had made a detailed study of them. He testified that he was familiar with the Exhibit 6 showing the production of these royalties down through 1964. He then testified (R. 93-94):

"Q. You have heard my testimony that my basis for this 6,152 shares is $37.00 per share. On the basis that the Government so far has allowed me a deduction being 27-1/2% roughly of the royalties only that the trust gets, and with no deduction from the income by way of dividends from Trinity Petroleum, Inc., I would have to receive $827,236.36 before that 27-1/2% would allow me to recover my $37.00 per share. Based on your long experience as an expert geologist and familiarity that you have with these properties and the length of time that they have been producing, state whether or not under those circumstances it is your opinion I will be able to recover my $37.00 per share.

"A. No, sir."

He further testified concerning making an estimate of the production from these properties and arriving at a figure to be used for cost depletion (R. 95-96):

"Q. Let me say, Mr. Beatty, do you know that these are royalties in 36 fields in six states. State

whether or not as a geologist you think any reasonable estimate could be made of the amount of oil and gas to be produced on these properties on which you could base a cost depletion figure?

"A. No, sir. It could not. In order to work these properties make an estimate, it would take a number of years to do it. For instance, in the case of Timbalier with over 480 sands, your estimate for it, simply the calculations, would be approximately a day for each sand, and that would be most in working out the structure of the field; and it would take the other fields a proportionate length of time, it would be an inordinate amount of time, and when you get your answer it would be incorrect because of changing conditions. You have a number of things happening. Wells would go to water and change conditions, so it would be just a never-ending thing and you would never come up with an answer until the fields are exhausted.

"Q. State whether or not you have ever had to revise estimates you have made on different properties.

"A. I don't know anybody that hasn't had to. I know I have had to and I am not by any means alone in that."

APPENDIX E

HISTORY OF PROVISIONS FOR DEPRECIATION AND DEPLETION

Revenue Act of 1916

SEC. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

* * *

Seventh. A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade;

Eighth. (a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow;

Revenue Act of 1918

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

* * *

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

* * *

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: * * * Provided further, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property

is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter;

Revenue Act of 1921

SEC. 214. (Same as in 1918 Act).

Revenue Act of 1924

SEC. 214. (a) In computing net income there shall be allowed as deductions:

* * *

(8) (Same as in 1918 Act).

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary.

Revenue Act of 1926

SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½% per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, *except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.*

* * *

SEC. 214. (a) In computing net income there shall be allowed as deductions:

(8) (Same as in 1918 Act).
(9) (Same as in 1924 Act).

Revenue Act of 1928

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(k) (Same as in 1918 Act).
(l) (Same as in 1924 Act).

* * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * *

(b) Basis for depletion.—

* * *

(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—(Same as Sec. 214(a)(9) of 1924 Act).

Revenue Act of 1932

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(k) DEPRECIATION.—(Same as in 1918 Act).
(l) DEPLETION.—(Same as in 1924 Act).

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * *

(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross

income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, *except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.*

Internal Revenue Code of 1939

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(1) DEPRECIATION.—(Same as in 1918 Act).

(m) DEPLETION.—(Same as in 1924 Act).

* * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * *

(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, *except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.*

Section 23(l) of the Internal Revenue Code of 1939 as amended by Section 121 (c) of the Revenue Act of 1942

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(1) DEPRECIATION. — A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or
(2) of property held for the production of income.

* * *

Revenue Code of 1954

SEC. 167. DEPRECIATION.

(a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or
(2) of property held for the production of income.

* * *

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) GENERAL RULE.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *

* * *

SEC. 613. PERCENTAGE DEPLETION.

(a) GENERAL RULE.—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). *In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.*

(b) PERCENTAGE DEPLETION RATES. — The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

27½% Depletion Provision

The 27½% depletion provision was inserted in Section 204 of the 1926 Revenue Act. The 1926 Act as introduced in the House did not have that provision but the Senate put it into Section 204. The report of the Senate Finance Committee on that point states (1939-1 (Part 2) Cum. Bul., Committee Reports, pages 345-346):

> "The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration your committee recommends that in the case of oil and gas wells the allowance for depletion shall be 25 per cent of the gross income from the property during the taxable year. The provision of existing law limiting this amount to an amount not in excess of 50 per cent of the net income of the taxpayer from the property is retained."

In the report to the House of the action of the Conference Committee it was stated (1939-1 (Part 2) Cum. Bul., Committee Reports, at page 362):

"Amendment No. 6: * * *

* * * *.

"The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration the Senate amendment provides that in the case of oil and gas wells the allowance for depletion shall be 30 per cent of the gross income from the property during the taxable year. The provision of existing law limiting this amount to an amount not in excess of 50 per cent of the net income of the taxpayer from the property is retained.

"The House recedes with an amendment providing that the depletion deduction based upon gross income in the case of an oil and gas well shall be 27½ per cent of that income instead of 30 per cent, and in the case of mines the Senate amendment is changed to provide that discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit."

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 1047

HOMER L. BRUCE, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question presented is whether petitioner is entitled to mineral depletion allowances calculated in a manner not specifically authorized by statute. Petitioner owns shares in a trust which owns a number of oil and gas royalties. The trust periodically distributes its net income, and petitioner is entitled to a depletion deduction on his share of the trust's royalty income. For the years in suit petitioner originally elected to take the percentage depletion deduction of 27½ percent authorized by § 613 of the Internal Revenue Code of 1954. His only statutory alternative, discussed below, would have been to claim cost depletion, computed as authorized by §§ 611 and 612 of the Code.

259-995—67

tions.[2] As it is, he is authorized to take the substantial annual deduction of 27½ percent of his adjusted gross income from mineral production—as he originally elected to do.[3] No other form of depletion allowance is sanctioned by the governing statutory provisions.

Petitioner's contention that he is entitled to a form of depletion allowance not authorized by Congress is based upon a confusion of concepts, well illustrated by his mistaken assertion (Pet. 11) that *Burnet* v. *Logan*, 283 U.S. 404, "is in all essential respects identical with this case." *Burnet* v. *Logan* dealt with the question of computing the gain on the sale of a capital asset. Under the governing Code sections a taxpayer is entitled, of course, to offset his cost basis against gross proceeds and only the excess is taken into income as capital gain. The taxpayer in *Burnet* v. *Logan* had sold her stock for a consideration consisting mainly of wholly-speculative contingent future payments, the total of which might well not equal her capital investment. The Court held that the sale was not a closed transaction and that the taxpayer was entitled to exclude the payments from gross income until her cost basis was recovered. In so holding this Court made it clear that its decision had no application to depletion deductions, saying (283 U.S., p. 412): "We are not dealing with royalties or deductions from gross income because of depletion of mining property." In the mineral depletion area Con-

[2] Cf., *e.g.*, *Commissioner* v. *Indiana Broadcasting Corp.*, 350 F. 2d 580 (C.A. 7), certiorari denied, 382 U.S. 1027.

[3] See *F.-K. Land Co.* v. *Commissioner*, 90 F. 2d 484 (C.A. 9).

gress has provided a detailed system of percentage depletion deductions for those cases where cost depletion either cannot be calculated or is inadequate. Thus, the rationale of *Burnet* v. *Logan* is inapplicable.[4]

Moreover, even if the *Logan* case were applicable in the depletion area, it applies only where the value of the taxpayer's interest is wholly speculative so that there is no way of estimating whether he can or will ever recover his investment. In the instant case petitioner's interest in the trust has an established market value which is far in excess of his cost basis (Pet. 31); additionally, the lower court found that if petitioner retained his trust interest, his total royalties would exceed his investment and concluded that, contrary to petitioner's argument, the allowable percentage depletion deductions may well exceed his investment (Pet. 29, 31). Therefore, *Burnet* v. *Logan* could have no application to the facts of this case. Since petitioner's total royalties will exceed

[4] Petitioner cites three early rulings by the Internal Revenue Service (1931–1933) for the proposition that *Burnet* v. *Logan* can apply to royalties (Pet. 12). But none of these rulings holds that a taxpayer *who qualifies for depletion deductions* may, in lieu of computing depletion under the specific Code sections (the predecessors to 1954 Code §§ 611–613), first receive tax free an amount of royalties equal to his cost basis. G.C.M. 9798, X–2 Cum. Bull. 221 (1931), specifically states that it is dealing with a taxpayer who was receiving royalty payments *which did not qualify for depletion deductions*. G.C.M. 11473, XII–1 Cum. Bull. 91 (1933), dealt with insurance renewal commissions rather than mineral royalties. And G.C.M. 11822, XII–1 Cum. Bull. 229 (1933), merely states the result reached in G.C.M. 9798 as an incidental part of the background for resolving a different question.

his capital investment, his theory—if accepted—would allow him first to recover his entire investment tax-free and thereafter to claim percentage depletion on all additional royalties received.

Petitioner is entitled to claim percentage depletion for each year in which he cannot make a reasonable estimate of future production; then in later years when he is able to make a reasonable estimate of remaining future production, he may use cost depletion to write-off any undeducted investment.[5] In this way his total depletion deductions will at least equal his investment.[6]

2. Petitioner also argues that if he is not entitled to greater *depletion* deductions than the Commissioner has allowed, he must be entitled to take *depreciation* deductions with respect to (1) the shares he owns in the trust and (2) the shares the trust owns in Trinity Petroleum Inc. The trust's assets consist solely of mineral interests owned outright and stock in Trinity

[5] A taxpayer is free to switch back and forth between cost and percentage depletion, from year to year depending upon which method produces the greater deduction. 1954 Code § 613(a).

[6] For example, if a taxpayer has an investment of $100,000 and during the first ten years of production he receives $150,000 in royalties, he would be entitled to $41,250 of percentage depletion (27½% of $150,000). If he then, for the first time, is able to make a reasonable estimate of future production, and his estimate showed that the remaining oil would be exhausted ratably over the next three years, he would be entitled to deduct his remaining basis of $58,750 ($100,000 less $41,250) ratably over the three years, even if these deductions exceed his income from the well in those years.

Petroleum Inc., a corporation which owns mineral interests. As to the mineral interests owned directly by the trust, petitioner's sole method for recovering his capital investment is depletion, not depreciation deductions (see *Von Baumbach* v. *Sargent Land Co.*, 242 U.S. 503, 524), and, as discussed above, petitioner is claiming the maximum depletion allowed by law.

As to the stock in Trinity Petroleum Inc., it has long been established that corporate stock is by its very nature a non-depreciable asset. See *United States* v. *Georgia Railroad & Banking Co.*, 348 F. 2d 278 (C.A. 5); *Exposition Souvenir Corp.* v. *Commissioner*, 163 F. 2d 283, 285 (C.A. 2); 4 Mertens, Law of Federal Taxation, § 23.49. Petitioner's reference to *New York Life Insurance Co.* v. *Anderson*, 263 Fed. 527 (C.A. 2), as supporting depreciation deductions for corporate stock is misplaced. In that case the Second Circuit held that the Corporate Tax Act of 1909 permitted a deduction for the decline in the market value of securities held by the taxpayer. A short time thereafter the same court held that the Revenue Act of 1913—the relevant portions of which are substantially the same as the provisions here in question—did not allow a deduction for "the depreciation [in value] of securities, which had not been sold during the year" (*New York Life Insurance Co.* v. *Edwards*, 8 F. 2d 851, 858), and this Court affirmed on that point (271 U.S. 109, 116). The point is now well settled. See *New York Life Insurance Co.* v. *Edwards, supra; G. E. Employees Securities Corporation*

v. *Manning*, 137 F. 2d 637, 641, 642 (C.A. 3); Treas. Reg. § 1.165–4.[1]

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APRIL 1967.

[1] Even if corporate stock qualified as a depreciable intangible asset, petitioner would have the burden of proving that it had a "limited" useful life, "the length of which can be estimated with reasonable accuracy" in order to obtain a depreciation deduction. Treas. Reg. § 1.167(a)–3; see also, *e.g.*, *Commissioner* v. *Indiana Broadcasting Corp.*, 350 F. 2d 580 (C.A. 7), certiorari denied, 382 U.S. 1027. Not only has petitioner failed to do this, but the core of his depletion argument is that it is impossible to estimate the life of the mineral reserves in question (Pet. 8).

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NO. 1047

IN THE

Supreme Court of the United States

October Term, 1966

HOMER L. BRUCE, *Petitioner*

v.

UNITED STATES OF AMERICA, *Respondent*

On Petition For A Writ Of Certiorari To The United States Court of Appeals For The Fifth Circuit

REPLY BRIEF OF PETITIONER

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---

REPLY BRIEF OF PETITIONER

I believe that, if this Court willl consider this my reply to the respondent's memorandum in opposition, it will grant my petition for certiorari. I want primarily to deal with misstatements of fact by respondent and his completely evading the issue under *Burnet v. Logan*, 283 U.S. 404, and his refusal to discuss at all the last sentence of section 613, dealing with percentage depletion, which reads:

> "In no case ~~would~~ shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section."

At the outset I ask where the respondent gets the basis for his flat declaration on page 1,

> "For the years in suit petitioner originally elected to take the percentage depletion deduction of 27½ percent authorized by § 613 of the Internal Revenue Code of 1954."

The years involved are 1960, 1961 and 1962 and I have never claimed the 27½ percent depletion but have asserted my right to recover my entire basis under *Burnet v. Logan,* I quote the following from an exhibit attached to my income tax return for 1960:

> "Trinity Petroleum Trust, Texas National Bank of Houston, Trustee, reported for 1960 taxpayer's taxable income as $ 13,930.85 ordinary income and $738.24 dividend income. However, taxpayer owned 6,152 shares in the trust and received $20,732.24 in cash from the trust. This was community property of his with his wife Clara C. Bruce who passed away on October 14, 1959. For her Federal estate tax these 6,152 shares were valued at $37.00 per share or a total of $227,624.00, which is taxpayer's basis. Owing to the highly speculative character of the trust, taxpayer is entitled to recover this basis out of his receipts. *Burnet v. Logan,* 283 U.S. 404."

Furthermore, as shown by my original complaint (R. 12), the Commissioner assessed the additional taxes involved in the latter part of 1964 and on November 30, 1964, I paid the additional taxes for all three years. I set that out in paragraph 16 of my complaint reading as follows:

> "16. On November 30, 1964, plaintiff paid said $12,714.75, $14,178.90 and $17,761.62 of income taxes and said amounts of interest thereon of $2,744.12, $2,209.38 and $1,701.95 to the District Director of Internal Revenue for the Austin, Texas, District."

How then can respondent make the above statement and state again on page 4 that I originally elected to take the 27½ percent depletion?

Respondent refuses to meet the issue under *Burnet v. Logan,* supra. As shown on pages 11 to 13 of my petition, that case involved two different situations, the first one not being relied upon by me at all and being entirely beside the point but being the only one that respondent discusses. The first situation involved the sale of stock for an interest in payments of 60 cents per ton of iron ore from a mine. That is illustrated by the following at 283 U.S. 412 and 413:

> "The 1916 transaction was a sale of stock—not an exchange of property. We are not dealing with royalties or deductions from gross income because of depletion of mining property. * * * The consideration for the sale was $2,200,000.00 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. *The transaction was not a closed one.*" (Emphasis added)

I have never at any time relied upon that point in *Burnet v. Logan.* On the other hand, there was another situation involved and that was the money to be received by Mrs. Logan from a similar right in the 60 cents per ton which

she inherited from her mother. That is explicitly set forth at 283 U.S. 413-414:

> "From her mother's estate Mrs. Logan obtained the right to share in possible proceeds of a contract thereafter to pay indefinite sums. The value of this was assumed to be $277,164.50 and its transfer was so taxed. Some valuation—speculative or otherwise—was necessary in order to close the estate. It may never yield as much, it may yield more. If a sum equal to the value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment. We think a like rule should be applied here."

On page 4 of his memorandum respondent quotes the above statement by the Court that it was not dealing with royalties or deductions. That was in reference to the first transaction which was a sale. The Court certainly was dealing in the second transaction with royalties, that is, an interest in 60 cents per ton or deductions from gross income.

Regardless of respondent's statement in footnote 4 on page 5 that none of the rulings cited by me by the Internal Revenue Service applying *Burnet v. Logan* to oil and gas, I repeat that those rulings did apply to oil and gas that qualified for a depletion deduction. I set out in Appendix E, pages 42 to 48, of my petition a history of the provisions concerning depletion. As early as section 214 of the Revenue Act of 1918 there was the following deduction allowed

> "(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance

> for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: * * *"

Those are the same identical provisions now contained in section 611 of the 1954 Code. (Incidentally when in 1945 I argued the case of *Kirby Petroleum Company v. Commissioner*, 326 U.S. 599, Mr. Justice Black pointed out that the depletion provision required that depletion should be allowed

> "according to the peculiar conditions in each case"

and joined in the decision in that case for the taxpayer.)

Respondent says that I am wrong when I say that by G.C.M. 9798, X-2 C.B. 91 (1933) showed that the Internal Revenue Service applied *Burnet v. Logan* to oil and gas. That ruling involved royalties under an oil and gas lease paid for the years 1923 to 1926. As shown on page 43 of our petition, the Revenue Act of 1926 in section 204(c)(2) first provided for the 27½ percent depletion in addition to the general provision for a reasonable allowance for depletion of oil and gas. That 1926 Act applied to 1926. For 1926 the taxpayer in that case was subject to the provision for reasonable allowance and also to the provision for 27½ percent. Yet the Internal Revenue Service in the ruling stated at page 224 in reference to an oil and gas royalty:

> "In this connection, it is considered unnecessary exhaustively to review the facts. This case is regarded as similar to the Logan case, particularly in the essential fact that in each case there are indeterminate future payments to be made dependent upon

> the yield of mineral products from the property involved. The taxpayers should be allowed to recover the full amount of their capital before treating any portion of the receipts from the contract as income. General Counsel's Memorandum 8650 is modified accordingly."

As heretofore pointed out, the 1926 Revenue Act and all later provisions down through the 1954 Code providing for the 27½ percent depletion stated expressly:

> "In no case ~~would~~ shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section."

Section 611 provides that there shall be a reasonable allowance for depletion. This has been in effect since the Revenue Act of 1918, and yet in *Burnet v. Logan* and other cases and in rulings of the Internal Revenue Service, as above pointed out, where it is uncertain as to how much a taxpayer will recover from oil and gas, he is entitled to recover his basis before being taxed. Respondent says the record shows I will recover my basis. That is true, but the record also is uncontradicted that at 27½ percent depletion I will never recover my basis. Respondent says that I can compute my depletion on a cost basis or take 27½ percent depletion and I have no other choice. In other words, if 27½ percent will not return my basis and it is impossible to compute my cost depletion, as is uncontradicted in this case, I am restricted to 27½ percent. However, section 613 provides that the allowance to me of 27½ percent shall in no case reduce my allowance for depletion if computed without reference to section 613. Frankly, this argument of the Government is wholly unsound and is contrary to the whole history of section 613 and should not be allowed to succeed.

But respondent still says that the fact that the certificates of interest in the Trinity Petroleum Trust are selling for more than my basis precludes me from taking the depletion I claim. This, of course, is directly contrary to the holding of this Court in *Fribourg Navigation Co., Inc. v. Commissioner*, 383 U.S. 272, in which this Court said:

> "The Commissioner argues that depreciation deductions are designed to give a taxpayer deductions equal to the 'actual net cost' of the asset to the taxpayer, and since the sales price of the *Feuer* exceeded the adjusted basis as of the first of the year, the use of the ship during 1957 'cost' the taxpayer 'nothing.' By tying depreciation to sales price in this manner, the Commissioner has commingled two distinct and established concepts of tax accounting—depreciation of an asset through wear and tear or gradual expiration of useful life and fluctuations in the value of that asset through changes in price levels or market values."

In that case this Court held that a rise in sales price had nothing to do with depreciation and the same rule applies to depletion.

While it is recognized that deductions are generally stated to be allowed by Congress as a matter of grace, this is only true where Congress specifically denies the right to a specific deduction. On the other hand without such a denial, the tax laws are generally administered to provide for a tax upon net income, for example, as shown on pages 9 and 10 of our petition, this Court said in *Commissioner v. Tellier*, 383 U.S. 687:

> "We start with the proposition that the federal income tax is a *tax on net income*, not a sanction

against wrongdoing. That principle has been firmly imbedded in the tax statute from the beginning. * * *"

CONCLUSION

I realize that in general this Court grants petitions for certiorari where there is conflict between the instant case and specific decisions by other courts. While I have not cited any specific case in conflict, nevertheless in my opinion the holdings below are definitely in conflict with the decisions cited in this reply brief and in my petition. This case is very simple and, if certiorari should be granted and the case be set down on this Court's summary docket, it could be disposed of very quickly. Then the taxpayers and their counsel would know whether or not the last sentence of section 613 reading:

> "In no case ~~would~~ shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section."

is of any force or effect.

It is respectfully prayed that my petition for writ of certiorari be granted.

Respectfully submitted,

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